

STRUDWICK

Wealth Strategies

“Innovation Equals Opportunity”



The Spiral's Second Ring

By Barry Strudwick

With low interest rates and tax cuts sparking a consumer spending spree, Wall Street was able to bask in the warm glow of a surging stock market this summer. After three years on the endangered species list, is the Bull back? We remain skeptics and have used the rally as an opportunity to ***again reduce stock market exposure.***

Wow! Headlines this week touted an incredible GDP growth rate of 7% over the past 3 months! If this doesn't mean much to you, think of a baseball player going on a .700 batting tear for a couple of months. But does it mean anything if the slugger's swats don't produce runs and more importantly "W"s? To echo the old TV commercial, ***“Where's the beef?”*** We've heard the sizzle from increased consumer spending, but where are the new jobs and, most importantly, the profits? After this intense burst of activity wears off, fueled by consuming a couple billion ***empty economic calories*** generated from refi's and home equity loans, will anything have

changed? Or will we be facing the same basic economic problem that we had before with a ***worldwide imbalance between supply and demand?***

Radio Thought # 88

“Dust off your Secret Decoder Ring!” The Media is beginning to focus on the enigma of a “Recovery” which produces neither jobs nor profits. Be alert for code words like “Overcapacity”, “Fierce Foreign Competition” and “Productivity Gains”. These are all media catch phrases for “deflation”.

*From the Mutual Perspectives Broadcast
October 20, 2003 on WYPR 88.1*

We suspect that once the economic sugar rush wears off, Wall Street will be faced with acknowledging that “economic expansion” hasn't added new jobs or profits. And then what happens to the paper gains from this summer's rally? ***Pooff!*** And, we'll be happy to have pocketed the windfall profits in advance.

From our vantage point, it appears the economy is ***slipping slightly deeper into deflation.*** This is a chilling realization, because deflation has the potential to spiral downward, getting progressively more difficult to reverse its course. Evidence? Have you seen the articles talking about how the economy is growing but we aren't seeing any new jobs being created? How about the ones lamenting the loss of high paying IT jobs to India and other emerging countries? Both trends reflect the deflationary pressures brought on by globalization.

If stoking the fires under U.S. consumer spending doesn't create new jobs, we have used up "future demand" with nothing to show from the refi orgy except a heap of new debt and maybe a straw hat from the island vacation.

Belizean Magic?
January 10 -14 2004

Does spending a long weekend with 4 wizards of international planning and investing sound like a profitable idea? Then join us on beautiful [Amerbergris Caye](#) for this relaxed and intimate gathering of gurus and independent investors. Topics include creating a tax wrapper around your investments with International Insurance, ground level opportunities in international real estate development and advanced estate and tax planning. Speakers include [Barry Strudwick](#), international Tax Attorney Joel Nagel, precious metal maven Michael Checkan and Mike Cobb, head honcho of the exciting new 2,200 acre Marriott Gran Pacifica resort. This is always a very relaxed and profitable gathering of friends and colleagues. Call or [email Stephanie](#) for details and reservations.

Our point has been, and remains: ***It is utterly foolish, even nonsensical, to believe the U.S. can spend its way out of what is fundamentally a global supply problem.*** Should the media wake up and grasp this very simple concept, watch out! The growing number of stories on this topic indicates they may be sitting up from their slumber. This could spook the herd and we certainly don't want to be in the path of this stampede. As Wall Street legend Bernard Baruch once said

"I made most of my money by selling too early".

But isn't the economy growing? Of course it is, but signs of ***sustainable growth*** are ***eerily absent***, such as jobs and plant expansions. In place of these are layoff announcements and price cuts. These are signs of increased global competition and deepening deflation. ***But didn't my stockbroker tell me his Wall Street firm's research department looked at deflation and decided it really wasn't a risk?*** After all the scandals of the last three years, do we have to remind you to consider the source? Wall Street has been quick to bury the boogey man of deflation because it's impossible to sell stocks in an environment of falling profits. The Dreaded D-Man is a demon not to be laid to rest by wishful thinking. Our real risk today is that we've already spiraled into the icy grasp of ***Deflation's Second Ring.***

The ***"Spiraling of Deflation"*** is a very important concept to understand. Once rooted, Deflation can feed on itself, spiraling the economy into a deeper crisis. Why? Because if consumers slow down spending, the underlying imbalance of supply and demand gets worse resulting in yet more layoffs and even less spending. Deflation can creep up and catch an economy unaware because the ***First Ring*** of the spiral is a wonderfully exhilarating ride for consumers as interest rates drop. Didn't you feel good when you refi-ed your mortgage and the paper value of your house went up over the past 3 years? The average person refi'ing a mortgage pulled out and spent \$30,000!

But in the ***Second Ring***, the sledding gets tougher. If the imbalance between

Supply and Demand continues, fierce *price wars* erupt. In turn, management is forced to *slash costs*. After the easy cost savings are realized, the fight for survival calls for more dramatic actions. Have you noticed almost daily reports of U.S. plants being shuttered and jobs lost with production “outsourced overseas” due to “fierce international competition”?

Radio Thought #86

Beware Blindly following old “Rules of Thumb” which could give you a poke in the eye right now. If you don’t want to get your asset allocation handed to you, NOW is the time to make adjustments for a world where supply dominates demand!

A global shift in the balance of supply and demand has altered the long term relationship between stock and bonds. Don’t assume the old 60 /40 balanced portfolio is the automatic solution going forward.

From the [Mutual Perspectives Broadcast](#) October 6, 2003 on [WYPR 88.1](#)

When these U.S. workers are laid off and the jobs lost, doesn’t the economy lose both present and future consumers, or “demand” declines? But what about “supply”? Well, if the jobs were simply moved offshore, doesn’t supply remain the same? So falling demand and the same supply, means *continued price wars and falling profits*. If the profits predicted by Wall Street fail to materialize, the air gets let out of the stock market.

But things can get worse. In the *Third Ring*, the consumer wises up to falling prices and starts to *defer purchases*, which causes demand to stall. This creates an even larger supply/demand imbalance which spirals into more layoffs and plant closings. This is what Greenspan refers to as “*corrosive deflation*” and we simply call “*depression*”.

Greenspan and Co. recognize these perils and are working very hard to avert this scenario. However, it’s every bit as important to understand that they freely admit publicly they have *never dealt* with this problem before and aren’t quite sure what will work.

The all *important question* is whether we can stop the slide down the slippery slope. The Answer? At this point, *we simply don’t know*. But until we see firm evidence to the contrary, we’ll continue to “connect the dots” we’ve been following for the past several years and assume the same progression. This calls for 1) *continued price wars*, 2) *continued layoffs*, 3) *more plant closings*, 4) *falling interest rates*, 5) *lower profits*, and ultimately 6) *falling stock prices*.

If you’re interested in our International real estate investments, please [contact Barry](#) for more information.

While these are very weighty issues, let’s examine what this means for our investment strategies. As we’ve done the past several quarters, we’ll start with the issues that have the most immediate impact on your investments and work

down to other thoughts which we think are important to keep an eye on.

1) Our strategy has worked well this year with most accounts up for the **first 9 months of the year** with both our stock and bond positions performing very well.

However, we continue to see **the clouds of global deflation darken**. This requires that we **take further steps to protect these gains and capital**.

2) With respect to the **U.S. stock market**, we've had **strong performance** with gains in excess of 25% in most accounts. This has pushed up our exposure to stocks requiring us to rebalance at this time. Accordingly, we will be taking some profits and trimming our positions to about 35%.

3) The huge run-ups in the tech and biotech sectors offer a good starting place to take profits. **The NASDAQ Biotech** ETF is up 48% YTD 9/30 (Ticker symbol IBB) and the **Dow Jones U.S. Tech Sector** fund (Ticker symbol IYW) is up 38% YTD 9/30. We trimmed Biotech last quarter and will do it again now. While we're Bullish long term, it's likely ahead of itself right now.

Market Cap	Year to Date (9/30/03)
S&P 600 Small Cap Index (IJR)	22%
S&P 400 Mid Cap Index (IJH)	20%
S&P 500 Large Cap Index (IVV)	14%

4) Over the past several years we've made the right call to heavily **overweigh the small and mid cap sectors** of the U.S. stock market. Our thinking is that these somewhat smaller companies might be more nimble in dealing with the competitive challenges presented by global deflation.

5) With the recent **scandals** with both the NYSE and Mutual Fund industry, we've continued our shift away from mutual funds to Exchange Traded Funds (ETF's). These are baskets of stocks which greatly reduce the **expense ratios** and also offer **higher tax efficiency** relative to traditional mutual funds. For example, the ETF funds listed above have annual expense ratios which are all at 20 basis points or less versus the average of all stock mutual funds of 140 basis points. ETF's also have lower portfolio turnover ratios making them more tax efficient.

Radio Thought #87

Now's a good time to grow your hedges to avoid getting clipped in the stock market! Add to positions which are not linked to the gravitational pull of the S&P 500 such as global commodities and hedged stock funds.
Call us about some options here.

From the [Mutual Perspectives Broadcast](#) October 13, 2003 on [WYPR 88.1](#)

6) An important part of our overall strategy has been our **"Market Neutral"** holdings. These are

holdings which we believe have good long term prospects but are not directly linked to the overall performance of the U.S. stock market. At this time we will be **increasing our allocation** to this portion of our strategy as both the domestic stock market and bond markets get tougher to play. Our market neutral funds have held up nicely so far this year of about 8.5% for the first 9 months of the year. Currently our core market neutral strategy consists of **Merger** (MERFX 8.5% Ytd) **Gateway Index Plus** (GATEX 8% Ytd) and **Oppenhiemer Real Asset** (QRAAX 8% Ytd). As we suspect profits will be challenged and interest rates might be more turbulent, we will increase our allocation to market neutral positions to 20% to 25% of most accounts.

7) Here is a **key concept** to focus in on which many people skip over in their mental calculus, especially the media: In a **Global economy** with **excess manufacturing capacity**, increasing “demand” in the United States through low interest rates and tax cuts **does not** automatically translate into profits for U.S. companies. Why? Because both U.S. and foreign companies will be competing for the same U.S. consumer dollar. The magnitude of excess global supply means both U.S. and International companies might still have to cut prices (and sell at a very low **profit**) to get the business. Increased sales without increased profits do not benefit stock investors.

8) **Here’s why:** Even with increased demand and a “growing” economy,

manufacturers currently **do not** have **“pricing power”** or the ability to increase prices (and profit margins) as demand increases. Many manufacturers are faced with the dilemma right now that every unit is produced at a loss. Ford Motor loses about \$3,500 on every car it produces right now! But they are not alone....thousands of companies in hundreds of industries are in the same boat.

Radio Thought # 82

Whooh Mabel!!!! Does that sputtering sound mean the engine’s outta gas? If so we better pull off to the side of the road before we get squished like a pan cake! The engine that has been driving this recovery is the hyper inflated house values caused by low interest rates. This has allowed consumers to pull out and spend billions in home equity. Now, with higher interest rates the average house value has dropped for the past 2 months. Is the engine out of gas?

From the [Mutual Perspectives Broadcast](#)
August 3, 2003 on [WYPR 88.1](#)

9) Why do companies **operate at a loss** or below their “breakeven point”? The reason is that they will continue to operate as long as they can make payments on their bank loans and bonds which were used to purchase their factories and equipment. Companies do this hoping conditions will change giving them pricing power or the opportunity to further

decrease expenses. But what if they don't? *Think about spirals!*

time and remain at our already low allocation...

Costa Curious?

Block out February 26-29

For a long weekend in Costa Rica

Want to learn first hand what the Costa Rica buzz is all about? Join [Barry](#) and [Dan](#) for a fun and fact filled 4 day tour of the beautiful (and red hot) Central Pacific coast. You'll see some ground level opportunities first hand as we tour the area between [Jaco Beach](#) and [Manuel Antonio](#). You'll also learn about the significant tax advantages of international real estate development. [Surf boards](#) are optional, but pack some blue jeans to wear when we go horseback riding at our beautiful [Del Pacifico](#) project. This trip is limited to the first 15 people. [Stephanie](#) has details.

10) If revenues drop below the point where you can service your debt, we reach the "*shut down point*" and you close the plant, lay off the remaining workers and turn the keys over to the bankers. If this happens to a public company, this also means you'll write off the assets and take a "*hit to earnings*". Certainly we have seen this happen with a number of companies already this year and the announcements continue. *Laying off workers also decreases demand.*

11) Clearly, *as investors*, we want to see signs of "pricing power" not simply increased consumer demand! Until we see concrete evidence of pricing power, we have to remain very cautious about the ability of even a red hot economy to produce profits. This means we remain very cautious about the prospects for stocks at this

12) *An old Wall Street adage is that the stock market moves in advance of an economic recovery.* We've been happy, in fact delighted, to see the rise in the stock in *advance* of hard evidence of higher profits. However, as we suspect that the level of profits already priced into the market will prove illusory, we have used this as an opportunity to reduce stock holdings over the last 6 months.



Just another Sunset at [Del Pacifico](#)

13) *Bonds* rise in value when interest rates fall and decline in value when rates rise. Since Bonds are almost equally weighted with stocks in our strategy, the direction of interest rates is a very important call. Right now there are two powerful *cross currents* colliding creating a turbulent environment. On the one hand, we have the strong *primary current* of global deflation driving interest rates down. At the same time, with the Fed aggressively fighting "deflation" by *printing* massive amounts of money, a cross current of rising interest rates has appeared as fears of inflation emerge.

14) **Which current is stronger?** Short run, we suspect the Market will initially respond with higher rates. However, longer term deflation's downward impact on interest rates will regain its dominance as the Fed's efforts to ward off deflation prove ineffective.

15) **What this means for investors:** rates on Government bonds and high quality corporate bonds will initially feel upward pressure due to the knee jerk reaction that increased money supply will automatically translate into inflation down the road. This means prices of U.S. Treasuries and High Quality Corporate **bonds will fall**. This is why last quarter we cut our holding of U.S. government securities by 1/3. **Intermediate Quality corporate bonds** will feel less impact because relatively they have a bigger cushion in the form of high credit risk and high spreads. Our positions in the **Loomis Sayles Bond** (LSBDX) fund are up 15% year to date.

16) We will continue to **build** our positions in **International bonds** for two reasons. First, the Fed efforts to drive down the value of the dollar should cause bonds valued in other currencies to profit. In addition, Europe is experiencing a more severe economic slow down. This increases the odds that their central banks will cut rates further to stimulate their economies. We have established positions in the **Julius Baer Global Bond** (BJBGX 5% Ytd) fund and **PIMCO Global Bond fund** (PCIIX 1.5% Ytd)

17) As a longer term trend we will also start building some new positions in the **bonds of emerging markets**. The new rationale is simple: if the U.S. and Europe are both losing jobs to the emerging markets, it follows that economic growth is shifting to these countries, improving the credit quality of these bonds. This is a longer term trend and we will build these positions over time. Our initial positions will be approximately 5%. We currently have positions in the **TCW Galileo Emerging Market Income Fund** (TGEIX 17% Ytd) and **T. Rowe Price Emerging Markets Bond Fund** (PREMX 15% Ytd) among others.

Radio Thought # 89
EI EIORevisited
..... "Energy Innovation" and
"Education and the Internet"
are two deflation resistant
investment themes that should
prosper even with the Boogey
man of deflation is just around
the corner.

We're adding to these types of
positions.

From the Mutual Perspectives Broadcast
October 27, 2003 on WYPR 88.1

18) In a similar theme, as jobs are lost in the developed economies, ultimately new wealth will be created in the emerging markets and the stock in these markets will rise. We will build our emerging market equity positions using the Barclay's **Emerging**

Market Index (EEM, 37% Ytd) as a core position and then tilting this position with closed end country funds emphasizing countries we see as most likely to benefit from the “outsourcing” of higher paying IT jobs such as India and Eastern Europe. Funds include the **India Fund (IFN, 44% Ytd)**, **ING Russia (LETRX, 65% Ytd)**, **Latin America Discovery Fund (LDF, 38%)**.



Big Boys and their toys at [Del Pacifico](#)

19) With respect to emerging market investments, several years ago when **Ireland** caught the first wave of internet fueled economic expansion, the immediate result was a **real estate boom** that far surpassed the impact on locally traded stocks. We suspect the same trend will emerge in other markets as well. One fund that specializes in global real estate is the **Alpine Global Real estate fund (EGLRX, 37.5% Ytd)** and we are establishing positions here.

20) However, the biggest gains in foreign real estate will be derived by **direct equity investment**. I have returned from spending several weeks in Central America where I visited real estate projects in both **Costa Rica** and **Nicaragua**. It's clear

that the seeds of capitalism, fertilized by the global telecom revolution, are beginning to bear fruit in both countries. We have developed private investment opportunities in both these markets. Please **contact me directly** if you would like to discuss these.

Thought # 85

So where are the Customers Yachts, Part 327?

With the Canary (hedge fund) having sung to Elliott Spitzer, a new Wall Street scandal is unfolding which will badly tarnish the reputation of the “consumer friendly” Mutual Fund Industry. If the press hops on this one it could batter an already fragile retail investor psyche.

This scandal gives yet one more reason to use “ETF’s rather than mutual funds. Add to this significantly lower expenses and higher tax efficiency, and you’ll understand why we are continuing to shift money away from traditional mutual funds.

From the [Mutual Perspectives Broadcast](#)
October 24, 2003 on [WYPR 88.1](#)

Now comes a series of “**Deep Thoughts**” to ponder on a sleepless night.

21) Does the Fed have the correct **tools** to unilaterally battle what is at its root a worldwide economic problem? If deflation is a GLOBAL monetary and supply problem, is it realistic to expect Alan Greenspan and the

Federal Reserve to fix it by themselves? Or do we need international intervention/cooperation?

22) Without a clearly acknowledged crisis of “Global Deflation” at hand, who in this *election year* wants to grab the political lightning rod “international cooperation” with the *French, Germans, Russians and Chinese?*



No lone cowboy here! Barry & Daisy hard at “work” riding the range at [Del Pacifico](#).

While the “*Lone Cowboy*” approach might work in Afghanistan and Iraq, we doubt it will remedy a global monetary crisis. In addition when viewed in the light of a worldwide supply/demand imbalance, Washington’s current economic strategy of trying to “spend our way” out of the imbalance is absurd but because of the potential spiraling of deflation, not comical.

Despite the hype about improving corporate earnings, let’s stay cautious at this point.

Barry Strudwick

October 20, 2003

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ABOUT BARRY STRUDWICK...

Barry Strudwick serves an international client base of individuals, investors and entrepreneurs designing and implementing wealth enhancement and protection strategies for over 25 years. *For private consultations Barry Strudwick & Dan Somerville are available to meet with you. Please contact them to arrange a meeting. We can be reached by calling*

(410) 727-6444 or via e-mail at invest@noload.com